CENTER ON FEDERAL FINANCIAL INSTITUTIONS

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The Center On Federal Financial Institutions (COFFI) is a nonprofit, nonpartisan, non-ideological policy institute focused on federal insurance and lending activities.

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House Government Reform Committee

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Thank you Chairman Platts, Ranking Member Towns, and committee members, for inviting me to appear today. I commend you for addressing this very important topic, particularly from the point of view of government efficiency and effectiveness -- a point of view sometimes neglected elsewhere.

I am President of the Center On Federal Financial Institutions, which we call COFFI. We are a non-partisan, nonprofit think tank that focuses on the federal government's immense lending and insurance activities, including PBGC. We do not advocate positions, instead dedicating ourselves to providing objective financial expertise to help policymakers such as yourselves evaluate the pros and cons of potential actions. COFFI has published a large volume of reports on PBGC, which are available on our website, www.coffi.org. All opinions expressed today are my own and not necessarily those of COFFI.

I was an investment banker for almost two decades, principally with J.P. Morgan. My clients were insurance companies and banks, and I have analyzed hundreds, if not thousands, of insurers in that capacity. There are many relevant parallels with PBGC, although it also differs from private sector insurers in important ways.

Let's start by examining why PBGC exists. It is the third layer of protection to ensure that retirees who are promised a traditional pension benefit will actually receive that pension. The first layer of protection is the legally binding promise of the sponsoring company. Since corporate bankruptcies do occur, negating this promise, federal law requires a second layer of protection through the establishment and funding of a pension trust.

The intention is that pension funds will have enough assets to pay the full pension benefits even if the company were to go broke. However, pension funds can become underfunded for at least three reasons. First, pension investments can fall in value. A typical pension fund has 50% or 60% of its investments in the stock market, which we have all seen can be very volatile. Second, companies hike their retirement promises from time to time through union negotiations or in response to the labor market. Finally, companies have some flexibility in how much they contribute to their pension funds each year and sometimes choose to remain underfunded for some time.

Claims on PBGC arise when companies go bankrupt at a time when their pension funds are underfunded. PBGC takes over the assets and the pension promises of the terminated pension plans. On average, the assets have been about half as big as the liabilities.

PBGC charges pension funds a premium, set by Congress, for protecting their participants. PBGC's 30 year history demonstrates that its premiums are insufficient for the risks it is required to take on. It has a cumulative loss of $23 billion, which is somewhat more than the $21 billion, in today's dollars, of premiums it has collected over its entire life. This is consistent with a range of academic studies, which have concluded that the premium level is, at best, half of what it would need to be to cover expected claims. Some studies concluded that premiums covered as little as one-sixth of the costs.

COFFI has published the only detailed, public model of PBGC's finances. Our base case showed that PBGC would need a $78 billion infusion, in today's dollars, in order to avoid running out of cash over a 75 year time horizon, assuming present law and policy. This would make it the second-largest financial bailout in history, after the Savings & Loan crisis. Absent reforms or a rescue, our model shows the cash running out in 2021. PBGC has indicated that they do not expect cash exhaustion quite this quickly, but I believe we differ by only a few years. I encourage PBGC to make public the results and key assumptions of its own financial modeling.

So, what should Congress do? In keeping with the focus of your subcommittee, I recommend that Congress examine six areas where it could usefully help improve PBGC's effectiveness and efficiency.

First, Congress should stop making infrequent, ad hoc decisions about PBGC and the pension system, usually at times of crisis. Instead, it would be helpful to make some major strategic choices that are still unresolved 30 years after the passage of ERISA. Most importantly, it is unclear to what extent Congress wants PBGC to be a "social insurer" and to what extent a regular insurance company.

One of the marks of a social insurer, like Medicare, is that it spreads costs fairly equally across its insureds, with minimal regard for their relative risk. PBGC fits that pattern, since most premiums historically have been collected from a per capita charge. Even its additional variable premiums are related to only one aspect of risk, the level of underfunding, without regard for bankruptcy risk or the risk of a pension fund's investments.

Regular insurers try to charge premiums that will cover their future claims and expenses. PBGC theoretically fits *that* pattern as well, since ERISA requires that premium levels be adequate to cover costs and explicitly does not give PBGC access to taxpayer funding, except for a minimal ability to borrow from the Treasury. However, Congress retains the right to set premium levels and has chosen to set them at levels that have proven inadequate.

Congress could improve the situation by either affirming its intention that premiums be adequate to cover costs, and creating a mechanism to ensure this happens, or determining an upper limit to premiums, with the recognition that taxpayers would subsidize any shortfall.

Unfortunately, we now have the related issue of deciding whether premiums are intended to cover the existing $23 billion shortfall as well. Realistically, there are only two sources of funding for this sunk cost – employers and taxpayers. To the extent that employers are to bear the burden, there is a further issue of how quickly to collect the extra premiums. Many economists would argue for a one-time charge, in order to avoid distorting future decisions about benefit plans, but this creates the real possibility that such a shock would encourage many departures from the defined benefit system.

The next logical step would be to decide the principles on which the actual premium structure would be based. There appears to be a broad consensus that premiums should continue to be divided between a fixed, per capita, premium and a variable premium with some relationship to risk. However, no principle has been laid out as to what the purpose is of each element. Instead, there has been an ad hoc approach to the level. It would be good to decide on a principle to follow. For example, perhaps we want the fixed premiums to cover the costs of a normal year of claims, recognizing that most PBGC losses come from a few very bad years. Variable premiums would then be set to build a reserve in advance for abnormal losses or to defray them after the fact. Alternatively, fixed premiums could cover PBGC's general expenses, with all claims covered from variable premiums. These are just two of the logical possibilities.

Variable premiums could be further tailored to reflect the three main risks: bankruptcy, underfunding levels, and investment risk. Underfunding levels are the key to current-law variable premiums. The Administration proposes adding an element of bankruptcy risk to this by changing liability calculations for weaker companies. Finally, some academics and think tankers are pushing for investment risk to be included.

If Congress would make these strategic decisions, then it might comfortably delegate to PBGC the setting of the actual rates, after public hearings and with at least the possibility of a Congressional veto. Current law puts Congress in the position of setting rates, despite the fact that I am unaware of any economist or political scientist who believes this is a strength of Congress. Some authority has been delegated to other federal insurance entities, such as FDIC, to set premium levels based on specified criteria.

Similar issues arise in the areas of funding rules and restrictions on benefit increases for severely underfunded pension plans. Congress currently sets hard and fast rules that cannot be altered by PBGC to reflect changing conditions. These rules are also immensely complicated, since they result from political compromises and not an agreement on overall principles.

Second, Congress should ensure the most effective coordination of pension fund regulation. Pension plans are overseen by the Department of Labor, the IRS, other parts of Treasury, PBGC, and, at least for accounting, by the SEC. Perhaps this division of responsibilities works perfectly, but it is worth comparing it to the regulation of other financial institutions. This is a reasonable analogy, since a pension fund is very similar to a life insurer. It takes in money today and invests it in order to meet pension promises spread over many future years. It is worth noting that states, which are the primary regulators of insurance companies, generally have a single Insurance department to regulate all aspects of insurer behavior.

Third, Congress could optimize PBGC's ability to negotiate with troubled companies. When a private company runs into financial problems it will often negotiate a rescue by its banks that reduces the principal and interest on its loans, but allows the banks to collect more than they would in a bankruptcy proceeding. Under present law, the federal government has little negotiating flexibility and that flexibility requires the coordination of multiple agencies. One possibility would be to give PBGC the authority to grant waivers of contributions on a broader basis than currently resides with IRS.

Fourth, Congress should provide clear overall investment guidelines for PBGC and eliminate micro-management. The big question is whether PBGC should try to minimize risk by holding mostly bonds, which is the current strategy, or to invest more like the pension funds it insures, by holding a considerable proportion of its investments in stocks. Every new PBGC Executive Director reconsiders this issue and there have been several switches back and forth. It appears that each change has been based on philosophical views about PBGC's role and not by differing views of market conditions.

On the other hand, while leaving PBGC great flexibility on the big issue, Congress has made an artificial distinction between the investment of funds obtained through premiums and those obtained from failed plans. If the money walks in through one door, labeled "Premiums", it can only be invested in bonds. If the money walks in through the door marked "Plan Takeovers", then it can be invested in almost anything. No private financial institution would voluntarily operate this way and there appears little purpose in forcing PBGC to do so.

Fifth, Congress should encourage PBGC focus careful attention of developing an optimal strategic plan for the big growth spurt that it is going through. PBGC's job will be more than 5 times bigger by 2006 than it was in 2000, measured by annual pension payouts. Perhaps PBGC's management, whom I respect, has everything well under control, but I have never seen a company that did not perform better with vigilant shareholders. Congress can play that role here.

I am sometimes asked about PBGC's level of general expenses and I must confess that I have no idea whether there is a great deal of fat or the management is performing brilliantly at expense control. There is not good information publicly available to allow a comparison with the costs of those entities most similar to PBGC. Nor is it clear precisely how PBGC is estimating its costs going forward. This is particularly concerning since the federal budget rules do not provide strong incentives to watch expenses closely, as the large majority of expenses are allocated to the off-budget quasi-trusts.

However, I would also advise Congress not to be "penny wise and pound foolish". It may be time to give PBGC greater flexibility in compensation and hiring decisions for certain key positions. I understand that PBGC is currently looking for three top officers, a Chief Financial Officer, a General Counsel, and a Head of Risk Assessment. Legally, PBGC can offer top salaries that fall some $50,000 below what the SEC, for example, could offer for the same positions. This may be an unfortunate limitation at a time of dramatic challenges for PBGC.

This brings me to the final item. Congress should align federal budget rules relating to PBGC with economic reality. According to federal budget rules, PBGC has contributed $12 billion to deficit reduction over its life, even though GAAP accounting, which better reflects the economic realities, shows a cumulative **loss** of $23.3 billion. Bad accounting creates bad incentives. For example, Congress might have been more vigilant to balance premium and risk levels if the budget had reflected PBGC's true economic losses.

Many budget experts favor a form of accrual accounting for federal insurance programs, similar to the way that federal lending is handled under the Federal Credit Reform Act of 1990. Although accrual accounting opens up the possibility of certain types of gamesmanship, the history of the lending programs over the last decade suggests that accrual accounting can better align budgeting with reality than the simplistic cash accounting that is used today for insurance programs.

Thank you for the opportunity to testify. I look forward to your questions.